

# THOUGHTS ON THE MARKET

31<sup>st</sup> March 2020



## SUMMARY

- It was another good night on risk markets with equities and credit adding to recent gains, which made it four gains in the past six days for equities and 5/5 for credit as spreads came in. Despite the price lifts in both markets, it was hard to pinpoint what had changed other than potentially oversold conditions, bombed out positioning and on-going policy support as China cut interest rates. However, oil priced plunged another -7% to USD20.09 per barrel.
- Yesterday, the Australian government unveiled its latest economic support measure in the form of a 6-month AUD130 billion wage subsidy. This involves payments of AUD1,500 per fortnight for each employees of firms whose turnover has declined by -30% or more. The subsidy is about 70% of Australia's median income and will support around 44% of the workforce and 30% of the economy's 6-month wage bill.

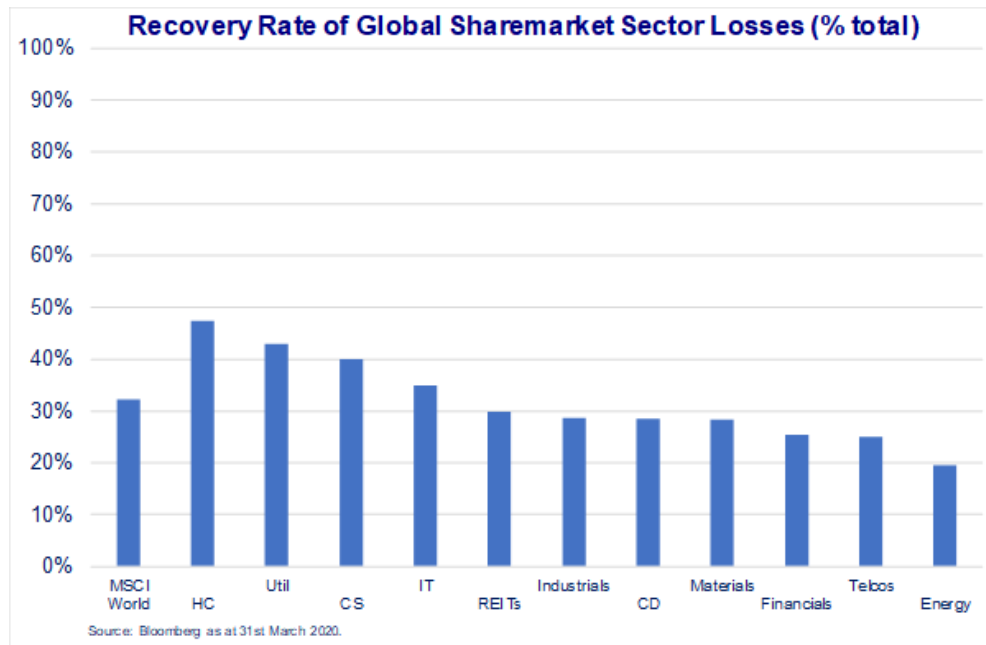
This third tier of government support won't prevent one of Australia's worst recessions in history, but the announcement is highly significant in that it will position the economy for a faster and larger initial bounce as labour market rigidities are diminished and it creates a pool of cash for household to unleash once the shutdown is eased, assuming that financial conditions do not tightened in H2 2020. However, in the next cycle higher household savings and deleveraging will be features of the Australian economy.

- COVID-19 cases in the US continued to rise at a strong pace overnight, but new daily cases in Europe fell for a third consecutive day, suggesting that social isolation is helping to contain the growth of the pandemic in the world's largest economic region. This bears watching, as it might send a message to the US that as costly as social isolation is, it is the only way to stop the spread of COVID-19.

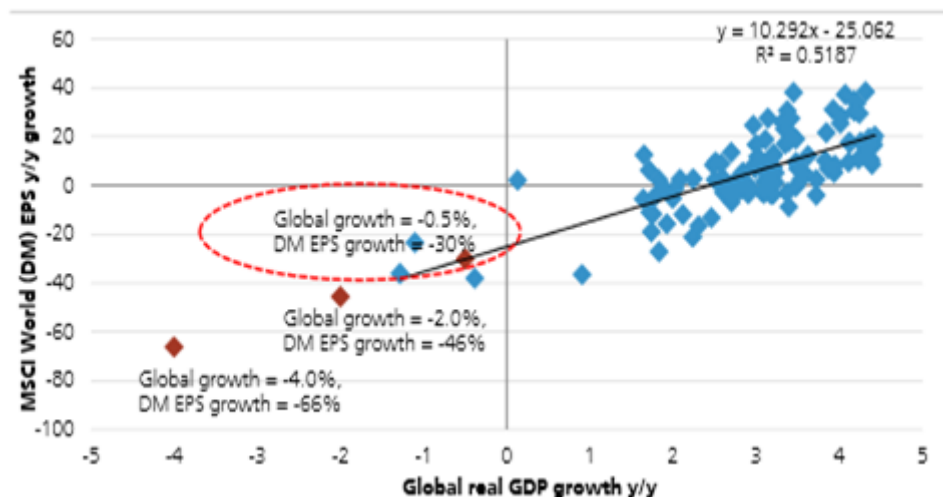
## FINANCIAL MARKETS

### • EQUITIES

- Regional sharemarkets had another good night, posting its fourth gain in the past six sessions. US markets (+3.4% d/d) led the way again with gains in all sectors led by healthcare (+4.7% d/d) as investors saw glimmers of optimism in efforts to ramp up testing for COVID-19 and President Trump heeded advice of the experts not to re-open the US economy in two weeks' time. Other large gainers were IT (+4.2% d/d), consumer staples (+3.9% d/d) and utilities (+3.7% d/d). This continues the trend over the past week where price gains have been led by defensive sectors, which have now recovered between 40% to 45% of their post mid-February declines (see chart below).
- European bourses followed a similar trend even though sectors performance was more mixed with gains led by materials (+4.2% d/d), energy (+4.2% d/d) and healthcare (+3.7% d/d), but industrials (-0.2% d/d) and financials (-2.8% d/d) declined. In Asia, losses in Japan (-1.6% d/d), Hong Kong (-1.3% d/d) and China (-1.0% d/d) were offset by the largest daily gain in Australia (+7.0% d/d) in 40 years (where defensive led the pace of gains like in other markets).

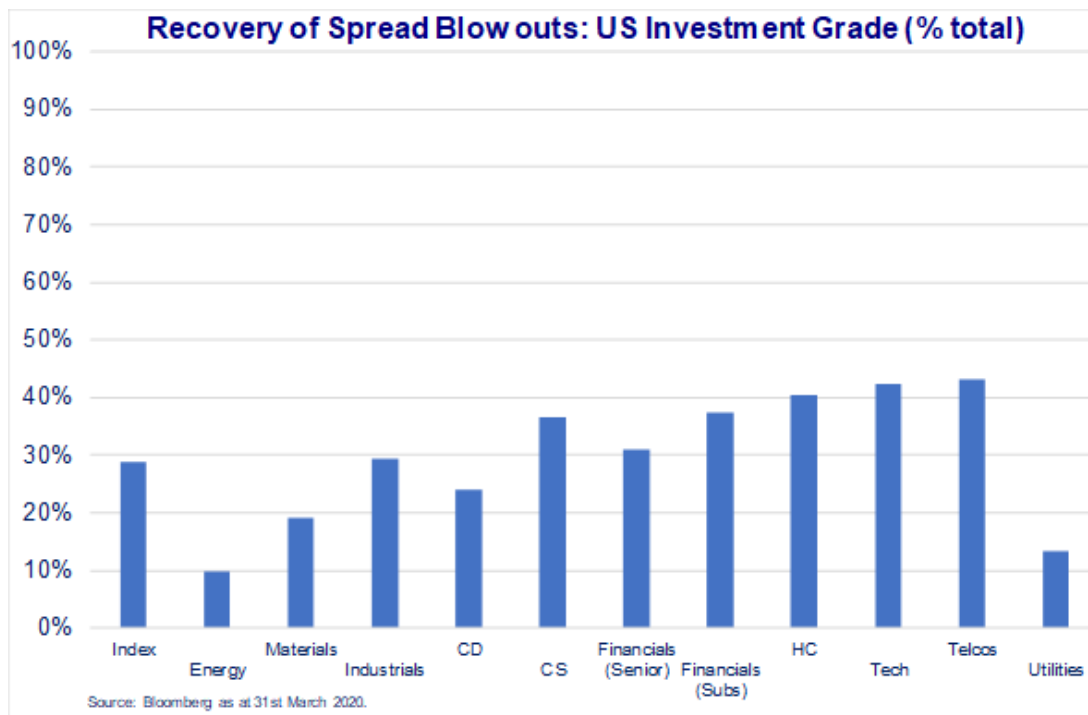


- Although markets have rallied over the past week, a key investment dynamic to anchor asset allocation decisions to is what kind of earnings decline is ahead for markets, and in many ways to key to understanding this is to firstly understand the nature of the decline. The period ahead is not, at present, a balance sheet problem (although this could eventuate if the economic decline is larger than expected and policy makers don't provide more stimulus). Instead, it's a major corporate income shock and our base case of a -2.5% y/y decline global GDP in 2020 suggests that an earnings decline of between -30% to -50% is reasonable to expect given the historic relationship between global economic growth and global corporate earnings growth (see chart below). However, if economic lockdowns are more extended than a couple of months, risks here are to the downside.

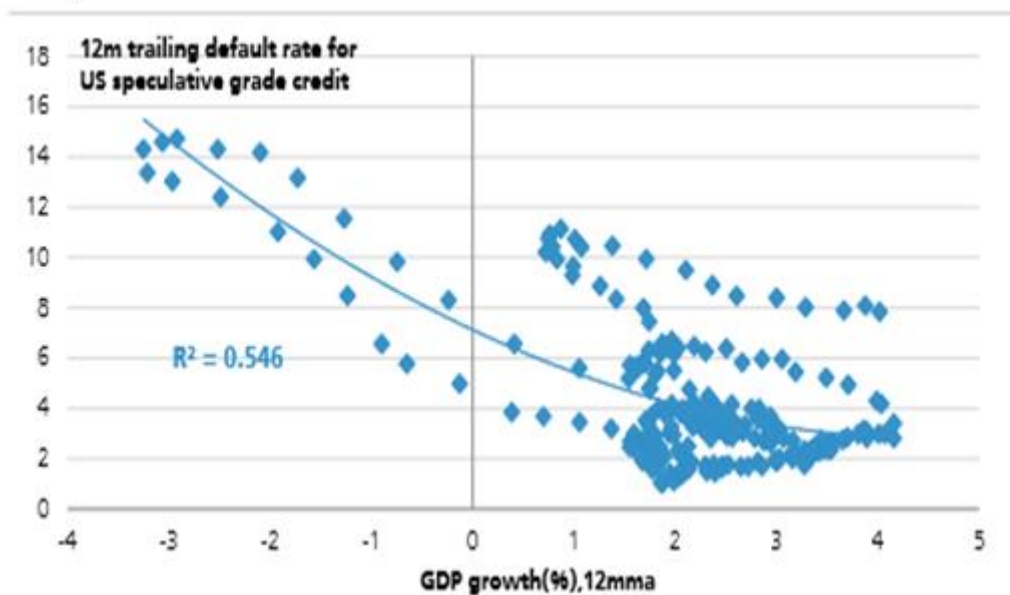


## • CREDIT

- US credit spreads narrowed for a fifth consecutive day even though oil prices plunged another -7% and closed at 20.09 per barrel. There were across the board reductions in spreads in both US IG and HY markets, with both sectors having now recovered just under 30% of the spread blow out from mid-February (see chart).



- A key question for investors is what default rate is likely from the impending growth hole that is ahead. At present, there are many unknowns here, including the length of the recession, its depth, the degree of regulatory forbearance and the effectiveness of direct stimulus to SMEs and banks. However, the historical relationship between growth and default rates in the junk part of the market at least gives us a guide as to what may be ahead. Our expectation of a -2.5% decline in global economic output this year, would be equivalent historically with the US seeing a 14% default rate in HY credit. UBS claims the market is priced for around 7%-8% defaults and if that is correct, there may be more pain ahead for credit investors.



The recovery rate of the Europe spread widening is well below that of the US as fiscal measures in the latter have been less egregious, central bank support has been more modest and the virus impact has been far greater than in the US. European IG spreads came in another 2 points overnight and but high yields increased by 6 points, meaning that European IG has recovered only 8% of the 190 bpts spread blowout and HY its better at 19%.

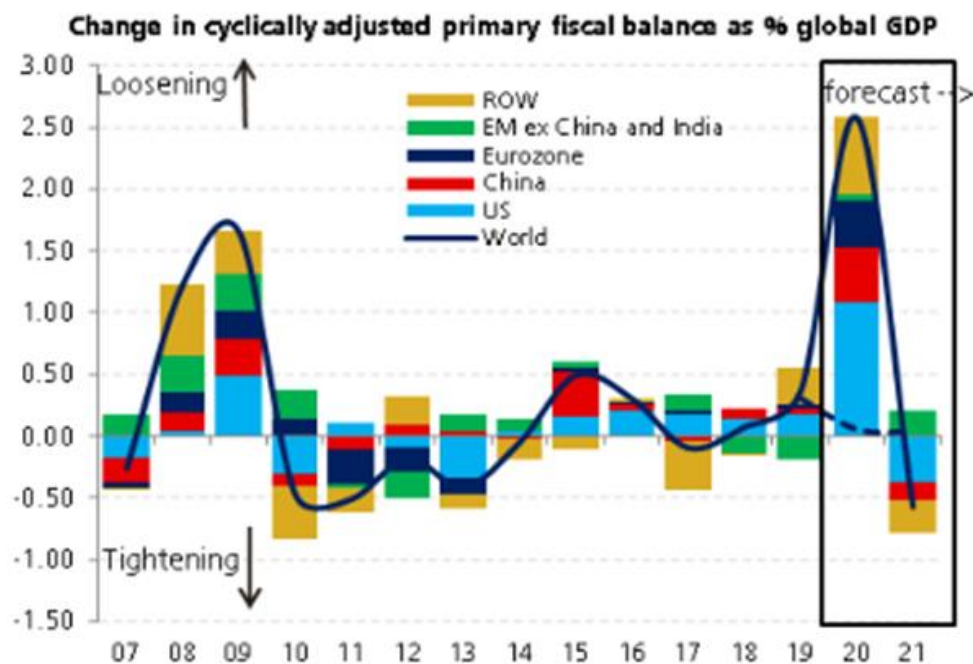
## POLICY ANNOUNCEMENTS YESTERDAY

- The Australian government announced yesterday a third stimulus package comprising AUD130 billion of wage subsidies over the next 6 months with AUD1,500 paid per fortnight for each employee of firms who's turnover has declined by -30% or more (and 50% for turnover of greater than AUD1 billion). We think this is huge and it comes on top of last week's AUD66 billion package and the AUD17.6 billion package announced the week before that bringing a grand total of AUD214 billion (or +10.6% of GDP) and most of this is released in the next 6 months so the stimulus is larger than that in its impulse.

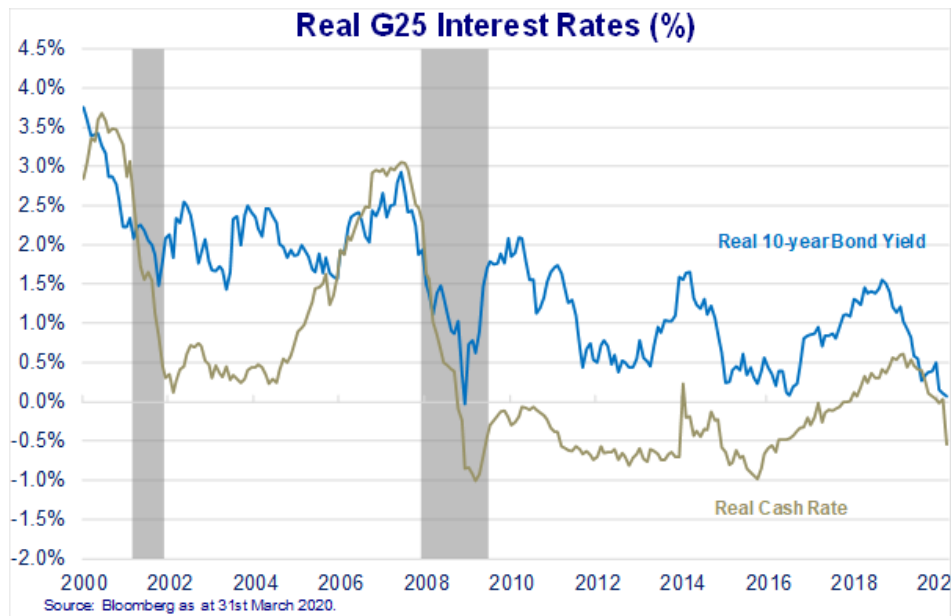
The subsidy is about 70% of Australia's median income and 44% of the workforce (according to the government) and 30% of the economy's 6-month wage bill, but for industries like retail and hospitality, which are the hardest hit, it could cover an employee's entire wage bill. The effect on the Australian economy depends how much activity is truly "shutdown", but every day is likely to be a circa -50% d/d GDP reduction and means in a 6-month full shutdown would lower GDP by 20%-25% annualised. Sadly, this third tier of policy won't prevent Australia's worst quarterly recession in history, as businesses are closed and hence households are likely to keep purchasing what they were going to purchase anyway, but it will go a long way to reduce supply side rigidities once the economic bottoms and it contributes to a large cashflow pool to use when things normalise.

The key is how much is saved and how is used, but we are now thinking that there will be sizable pass through to end spending (nothing better than having a spending spree funded by other taxpayers) when lockdowns are eased. This will get a strong recovery underway assuming financial conditions are not tightened in H2 2020, but eventually in the next cycle higher household savings and deleveraging will be features of the Australian economy thereby reducing trend growth. That said, it will be much harder for Australia's unemployment rate to get above 10%. This won't be the last Government announcement with rental assistance possibly to be released later this week.

- The global policy response is gathering momentum, but it is important to remember that a lot of the stimulus is not a "GDP" effect and that there is a major growth hole in front. Instead, this stimulus is aimed at keeping the production side of the economy (both manufacturing and services) intact to facilitate the recovery. Discretionary stimulus for 2020, which has a GDP effect, is now sitting at +2.6% of global GDP which is beyond the commensurate amount that was unleashed in both 2008 and 2009 (see chart below), so it's very large and this combined with monetary policy support of +1.5% of GDP (chart beyond that) gives a direct policy impulse of +4% of global GDP. However, when the global growth hole in the June and September quarter is much larger, the support is welcome and needed, it won't prevent the worst quarterly global downturn in history, but it does help mitigate the downturn and limits supply side rigidities in getting things moving again.



Source: UBS, Haver, European Commission, CBO



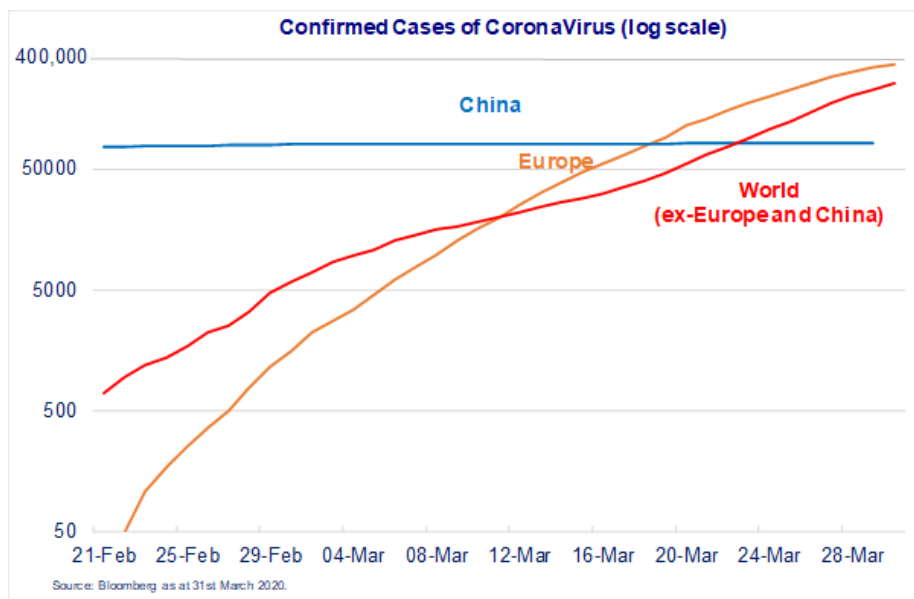
- The PBoC trimmed the 7-day reverse repo rate by 20 bps to 2.2% on March 30 having conducted RMB50 billion of 7-day reserve repos, which culminates in a total 30bps of rate reductions. While this does not automatically flow through to the 1-year Medium-term Lending facility and the loan prime rate, that is expected to occur very soon, which combined with previous reductions in the lower reserves requirement ratio, indicate that Chinese monetary policy has become more accommodative to support any rebound, and should help set the right conditions for fiscal policy to boost growth.

## THE GLOBAL ECONOMY

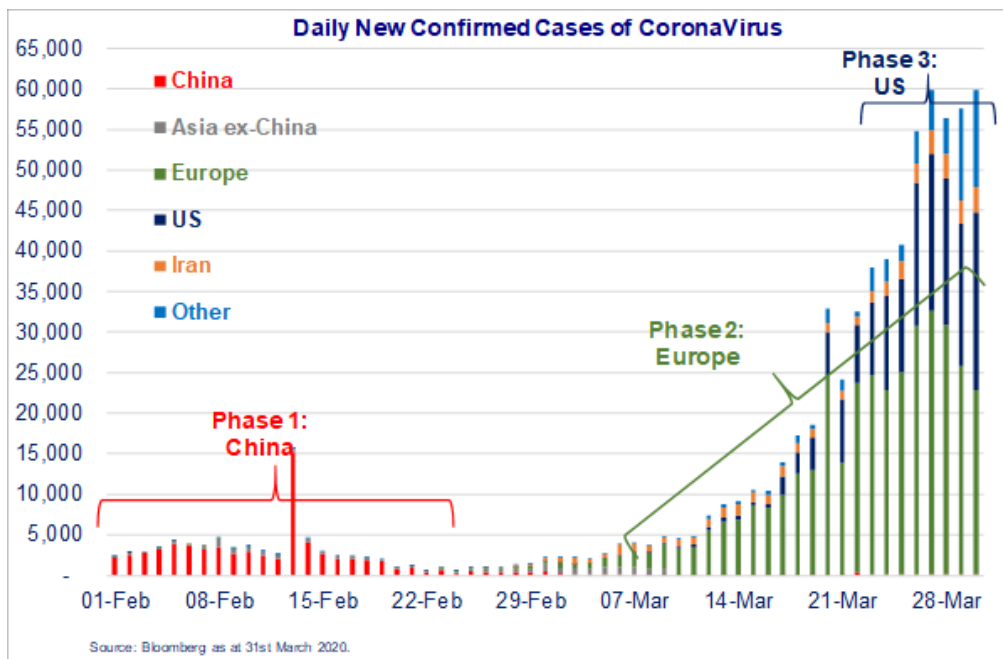
- There were no major economic releases.

## VIRUS UPDATE

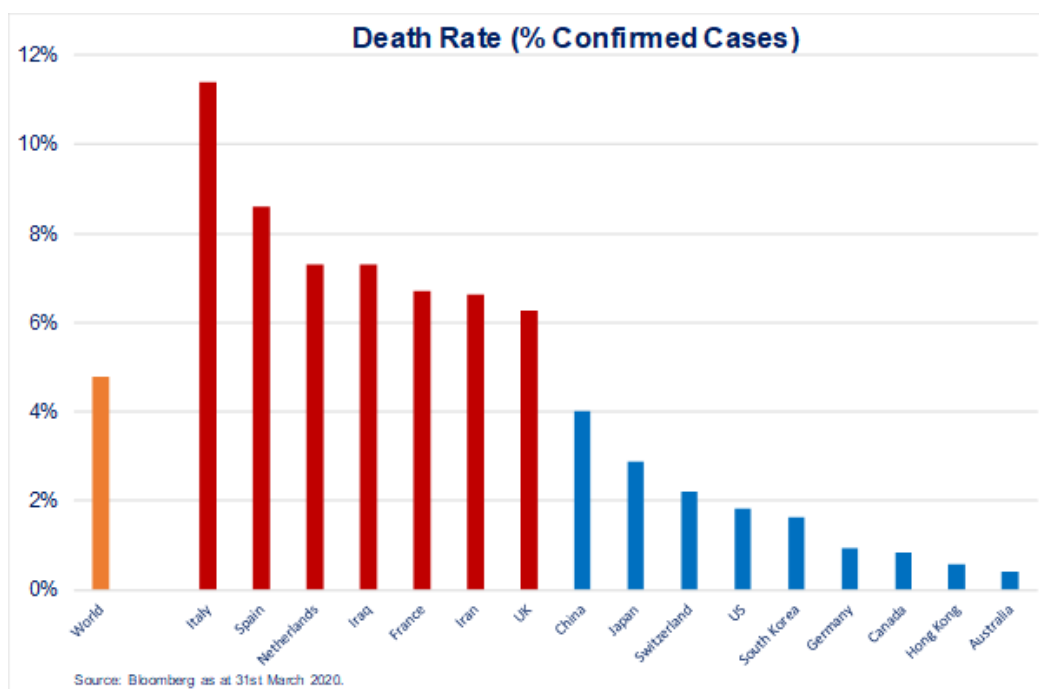
- Corona cases rose +59.2k overnight to 775.3k, deaths rose +3,229 to 37.1k and the death rate rose to 4.8% (20th rise in the past 23 days despite surging case numbers);



- Europe (+23,985 to 343.0k) continues to lead the world in terms of total cases, but the number of new cases declined for a third consecutive day. In contrast, the US had its worst day of new cases (+59k) and deaths (+729 to 2.9k), with Italy having its third worst day of deaths (+812 to 11.6k) which took it further beyond Spain (+538 to 7.1k) and China (+4 to 3.3k) combined.
- Among countries, the most cases are in the US (+21.9k to +159.2k), Italy (+4.1k to 101.7k), China (+76 to 82.2k), Spain (+5.2k to 85.2k), Germany (+4.0k to 66.1k) France (who had its third worst day of +4.5k to 45.2k) and Iran (who had its third worst day of +3.2k to 41.5k). Australia confirmed cases has increased (+381) to 4,361 which placed us 20th in terms of total infections.



- The global death rate has risen to +4.8% with another 3,229 fatalities bringing the global total to 37.1k. Death rates are highest in Italy (+0.4% to 11.4%) and Spain (+0.1% to 8.6%) where the health systems have collapsed, and above the global average levels in the Netherlands (+0.2% to 7.3%), Iraq (-0.4% to 7.3%), France (+0.3% to 6.7%), Iran (-0.3% to 6.6%), and the UK (+0.1% to 6.3%).





Yours sincerely,



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